Restrictive Covenants & Trade Secrets

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Sometimes employers' greatest employment problems arise only after a valuable employee leaves employment. The employer may find itself trying to prevent that departing employee from "stealing" trade secrets (such as client lists) or from "poaching" other employees of the employer, or clients of the employer. Some of the most litigated issues involve companies and their former employees who have tried – sometimes successfully – to take the employer's assets and use those assets to compete with their former employer. This chapter outlines steps that employers can take to shield their trade secrets, confidential information, and other assets (e.g., customer relationships) from theft by current and former employees.

DUTY OF LOYALTY TO CURRENT EMPLOYERS

Common law in most states imposes a duty of loyalty on all employees. Managers, officers, and others in a special position of trust owe an even higher fiduciary duty to their employers. These duties regulate employee behavior, mandating good faith and prohibiting actions inconsistent with the employer's best interests.

Employees who use company information to benefit themselves or a competitor violate their duty of loyalty. Individuals with a fiduciary duty have an even greater duty to act in the employer's best interest and may be required to take affirmative action for the employer's benefit. For instance, an employee who owes a fiduciary duty to an employer and discovers a new formula or way of conducting business may be required to disclose this information to the employer for its benefit. These common law rules do not strictly prohibit all competition; instead they prohibit actions in conflict with the employer's interests, such as the use of company resources or information to support or further competitive activities.

POST-EMPLOYMENT RESTRICTIONS AND RESTRICTIVE COVENANTS

Restrictive covenants refer to contractually imposed limitations and restrictions that flow from an employer to the employer's current or former employee and the employer. Covenants come in a variety of forms, but the two most common types are noncompete agreements that restrict a former employee from performing services for certain competitors in some or all capacities, and "nonsolictation" agreements that prevent a former employee from soliciting customers and/or fellow employees. Restrictive covenant agreements bind current employees and job applicants to do certain things and avoid others, during and after employment with the employer to whom the restrictive covenant obligations flow.

In the absence of a restrictive covenant in an employment relationship, a company's former employees generally may:

- work for a competitor immediately,
- solicit their former employer's customers and employee, and/or
- use or disclose confidential information that belongs to their former employer, or that was generated by the former employer.

In New York, in order for a restrictive covenant to be enforceable, there must be consideration, or a mutual benefit between the parties who are entering into the restrictive covenant agreement. Providing an employee with initial employment, or providing a current employee with "continued employment" is sufficient consideration in New York. To ensure that there is no dispute about the sufficiency of consideration, or a question as to what the consideration might be, it is recommended that the parties identify the consideration right in their agreement/document.

Restrictive covenants are disfavored under New York law because they operate as restraints of trade. Nonetheless, New York courts will enforce restrictive covenants if they are "reasonable" in scope. Specifically, a restrictive covenant will only be enforced to the extent that it is reasonable in time and area, and the employer proves that it needs the restrictions in order to protect the employer's legitimate interests, not be harmful to the general public and not be unreasonably burdensome to the employee. Therefore, the analysis of whether a restrictive covenant will ultimately be enforceable is highly fact-specific, depending on the job at issue, the employee who is subject to the covenant, and the industry and circumstances in which the covenant was executed.

Restrictive covenants fall into three main categories: (1) preventing an employee's release of confidential information regarding the employer, its customers, or its business in a way that could be helpful to a competitor; (2) preventing an employee's solicitation or disclosure of trade secrets; and (3) preventing harm to an employer currently benefiting from the special or unique services of his employee.

NONCOMPETITION COVENANTS

A noncompete clause or agreement restricts an employee from working or owning an interest in a competing business during the employee's employment with an employer. This ensures that the employee's time and loyalties are devoted to the employer/company paying the employee, and not the company's competitor. Thus, a noncompetition covenant is generally coterminous with the employee's employment. However, a noncompetition covenant is most commonly known as a post-employment covenant, that prohibits a former employee from obtaining employment with a competitor, or establishing a competing business.

NONSOLICITATION COVENANT

A nonsolicitation clause prohibits a current employee from soliciting the customers or vendors or employees of his employer, and trying to persuade them to purchase goods or services from a competitor. Thus, current employees owe a duty of loyalty to their current employer but, beyond any common law duty of loyalty, the employees are required to not solicit their employer's customers, employees, and vendors for the benefit of a competitor or competing enterprise. Like noncompetition covenants, a nonsolicitation covenant also applies after an employee's employment. It restricts an employee from trying to solicit unfairly after the employee's employment ends.

NONDISCLOSURE COVENANTS

Nondisclosure covenants prohibit an employee's use (during and after employment) of the employer's private, confidential, and proprietary information for any reason except the employer's business reasons. Nondisclosure agreements can generally be drafted very broadly, because they impose minimal restraint of trade.

Factors Impacting the Enforceability of Covenants

When examining the enforceability of restrictive covenants, New York courts evaluate four factors:

1. Whether the covenant protects a legitimate business interest of the employer.
2. Whether the covenant is narrowly tailored to protect the employer's interest and is reasonable (i.e., scope of activity prohibited, duration and geographic scope).
3. Whether the covenant creates an undue burden on the employee.

4. Whether the covenant is injurious to the public interest.

LEGITIMATE BUSINESS INTERESTS VS. UNDUE BURDEN

Courts evaluating the enforceability of a restrictive covenant first examine the nature of the employer's interest. The determination of whether a particular restrictive covenant is enforceable often turns on what is, in essence, a balancing of the employer's interests protected by the covenant on one hand, and the burden the covenant will place on the employee's ability to earn a living on the other.

Courts have deemed an employer's legitimate interest to include protection of trade secrets, proprietary information and certain customer relations. An employer's interest in customer goodwill is commonly protected by noncompete agreements. Even if the relationship with the customer has terminated, customer goodwill remains a protectable interest in New York. Customer goodwill is a legitimate business interest whenever the employee's relationship with customers is such that there is a substantial risk that the former employee may be able to divert all or part of the customer's business to the employee's new business or subsequent employer. Factors that a court will look to include:

- the frequency of the employee's contacts with customers and whether those contacts are the employer's only relationships with the customer;
- whether the employee had a relationship or contact with the customer predating employment with the most recent employer; and
- the nature of the functions performed by the employee.

For instance, there is a legitimate business interest in customer contacts when an employee is the employer's only representative in a particular locale, the employee services the customers in that locale frequently, and when personal contacts and a good service record are important in the employer's line of business. For customer goodwill to be a legitimate interest, it is often important for the employer to show that it spent significant time and money in developing the relationship. When the facts support it, it is also helpful, but not essential, to show that the employer introduced the employee to the customers at issue.

The protection of an employer's trade secrets or confidential information is also a legitimate business interest. New York courts, however, do not generally permit the employer to define the term "trade secrets" within a contract in a way that would include all information obtained by the employee during employment.

The scope of activities prohibited by a restrictive covenant must be stated with specificity. Overly broad restrictions on the scope of activities covered by the agreement can provide grounds on which an employee can attack the noncompete agreement. Also, the prohibitions within restrictive covenants must be clear and definite. Courts will construe a covenant narrowly and strictly against the employer. Any vague or unclear language will be interpreted in the employee's favor.

TIME AND GEOGRAPHICAL LIMITATIONS

Restrictive covenants must state the time and geographical limitations of the restrictions. There is no bright-line rule for what time and geographical limitations are acceptable. The ultimate question is whether the restrictions are limited to the extent necessary to protect the employer's legitimate interest. The length of a justifiable time restriction will be measured primarily by the length of time necessary to reduce or eliminate the employee's personal hold over customers or the confidential nature of information. Instead of a specific geographic area, employers can substitute the employee's former territory or customers.

MULTI-STATE EMPLOYERS

In today's workplace, employers often employ individuals outside the state where the business is incorporated or has its headquarters. The law in many states differs substantially from the law in New York on what it takes to be able to enforce a noncompetition agreement, what limitations are enforceable and for how long or even whether such agreements are enforceable at all. Therefore, careful thought must be given before attempting to have every employee sign a company's "standard" noncompetition agreement. Some states will disregard provisions of a noncompete agreement making the law of a more favorable state applicable to the agreement. Employers should review such agreements with their legal counsel to make sure that the agreement will be enforceable in the particular circumstances and that seeking to have it signed as a condition of employment will not result in liability under the law of the other state.

TRADE SECRETS

Employers who do not secure any restrictive covenants are not necessarily without recourse in the event that a former employee discloses or uses certain proprietary information. If that information constitutes a "trade secret," the employer will be able to invoke protections under both federal and state law. Because the federal law does not attempt to preempt state laws, employers will be able to invoke the protection of whichever law best serves their purposes.

In, 2016, the federal Defend Trade Secrets Act (DTSA) went into effect and it applies to any misappropriation of trade secrets after that date. The DTSA operates as an additional level of protection for employers by enabling them, as the owner of a trade secret, to bring a civil action if the trade secret is related to a product or service used in, or intended to be used in, interstate or foreign commerce.

Trade secrets are broadly defined in the DTSA to mean all forms and types of financial, business, scientific, technical, economic or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs or codes, whether tangible or intangible and whether or how stored, compiled or memorialized physically, electronically, graphically, photographically or in writing if (a) the owner thereof has taken reasonable measures to keep such information secret and (2) the information derives independent economic value, actual or potential, from not being generally known to and not being readily ascertainable through proper means by the public.

The trade secret definition highlights the importance placed on efforts by the owner to keep the information a secret. Although customer lists may constitute a trade secret, an employer will be hard-pressed to argue that point if key customers are identified on the company's website. Simply put, companies must take a consistent approach when it comes to identifying and protecting their trade secrets or they may lose them.

Under the DTSA, the owner of a trade secret may bring a civil action if the trade secret is misappropriated. There are three ways in which a trade secret can be misappropriated:

1. Someone uses improper means to acquire knowledge of it. This might include outright theft or bribery, electronic espionage, misrepresentation or breach of a duty to maintain its secrecy

2. The second is if the person acquiring knowledge of the trade secret knew or had reason to know at the time of disclosure or use, that the information was:

    - derived from or through a person who had used improper means to acquire it;
    - acquired under circumstances giving rise to a duty to maintain the secrecy of the trade secret or limit the use of the trade secret; or
    - derived from or through a person who owed a duty to the owner to maintain the secrecy of the trade secret or limit the use of the trade secret.

3. The third way is if the person knew or had reason to know that the trade secret was a trade secret and, before undergoing a material change of the position, obtained knowledge or had reason to know that the trade secret had been acquired by accident or mistake.

Several significant remedial provisions are contained in the DTSA that are not found in current state trade secret laws. The most potent of these is a civil seizure remedy under which an employer can obtain an order from the court providing for the seizure of property necessary to prevent the dissemination of the trade secrets. Such orders may be obtained ex parte, which means that only one side is present in court to make its case, but the statute makes it clear that these kinds of orders will be available only in extraordinary circumstances. In such cases, the DTSA requires clear proof that immediate and irreparable harm will occur if a seizure order is not issued. Any seizure order must provide for the narrowest seizure of property necessary to prevent irreparable harm and it must direct that the seizure be conducted in a manner to minimize any interruption of the business operations of third parties and, to the extent possible, does not interrupt the legitimate business operations of the person accused of misappropriating the trade secret.

If the trade secret is willfully and maliciously misappropriated, the court may award exemplary damages in an amount not more than two times the amount of the damages awarded as described previously.

The DTSA requires employers to provide a notice of this immunity to any employee, contractor or consultant in any contract governing the use of trade secrets or other confidential information entered into or updated after May 11, 2016. An employer that fails to provide this notice will be deprived of exemplary damages and attorney fees in any successful lawsuit for misappropriation of a trade secret. The confidentiality agreement does not have to contain actual notice of immunity if the employer provides a cross-reference to a policy document that sets forth the employer's reporting policy for a suspected violation of law.

Unlike the vast majority of states, New York has not adopted a version of the Uniform Trade Secrets Act. However, New York applies judicially established rules under the common law to protect information that amounts to a trade secret even in the absence of any written agreement. Whether or not information qualifies as a trade secret under New York law depends on several factors.

New York defines a trade secret as "any formula, pattern, device or compilation of information that is used in one's business and that gives him an opportunity to obtain an advantage over competitors who do not know or use it." Ultimately, the determination of what is a trade secret is generally very fact sensitive. New York courts have identified several factors they will consider in determining whether information constitutes a trade secret. Those factors include:

- the extent to which the information is known outside the business;
- the extent to which the information is known to the employees and others involved in the business;
- the precautions taken by the company to guard the secrecy of the information;
- the value to the company in having the information as against competitors;
- the amount of effort or money expended in obtaining and developing the information; and
- the amount of time and expense it would take for others to acquire and duplicate the information.

Companies that have trade secrets must take reasonable steps to protect them. A court will not issue an injunction or award damages against a former employee for disclosing the company's customer list when the company freely displays the same information on its website.

HIRING AND NONCOMPETE AGREEMENTS AND TRADE SECRETS

Employers frequently think of trade secrets and post-employment restrictive covenants only in the context of protecting their business from unfair competition by others. This is far too narrow a view. Consideration should be given in the hiring process to whether the applicant is under valid restrictions to a prior employer. Not only could such restrictions limit the suitability of the individual for the new job, but the failure to address legitimate restrictions could result in having the new employer dragged into court as a defendant in a claim for unlawfully interfering with the prior employer's contractual rights. While ignorance of such an obligation might protect the new employer from a claim for unlawfully interfering with the prior employer's contractual rights, this will be small consolation to a company that has invested time and money in the hiring process only to have to begin again.

Additionally, care should always be taken to ensure that an overly enthusiastic new hire does not upload onto the new employer's computer system any files or other documents that were wrongly acquired from a prior employer.

Employers should review their restrictive covenant agreements, confidentiality agreements, and employment policies to ensure that they define confidential information in a manner that courts will enforce. It is always wise to review periodically how the company is handling its own confidential information to ensure that loose practices or careless application of the rules do not cause it to lose legal protection that may otherwise be available.

RECOMMENDATIONS

Employers should have, as part of their standard onboarding packet, agreements that cover nondisclosure obligations and trade secret protection. To the extent an employee's position with the company warrants it, employers should also ensure to obtain from such employees a promise not to compete and/or not to solicit clients and/or employees of the employer after the employee's employment ends.

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